COMMENT / *By Joseph A. DiNuzzo*

Some Thrifts Converting Into State Savings Banks

Since the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act in August 1989, several federal and state savings associations in states with savings bank statutes have begun to change their charters to state savings bank.

A state-chartered savings bank is a hybrid between a commercial bank and a savings and loan association, with a mixture of commercial banking and thrift lending and investment powers.

Historically they have been insured by the Federal Deposit Insurance Corp. and regulated by the FDIC and the applicable state chartering authority.

The savings-bank charter alternative has become popular, in part, because of the thrift law's elimination of the Federal Savings and Loan Insurance Corp. and the transfer of thrift insurance responsibilities to the FDIC under the Savings Association Insurance Fund.

Mr. DiNuzzo is a partner in the Washington, D.C., law firm Breyer & Zinski, which specializes in representing banks and thrift institutions.

Some states with savings bank statutes require that institutions be insured by the FDIC to be eligible to become savings banks. Because all federally insured thrifts are now insured by the FDIC under SAIF, they may qualify to convert to savings banks under the applicable state statutes.

After conversion, the savings bank is subject to regulation by the state banking authority and, ordinarily, the FDIC.

Pioneer Federal Savings Bank, a $680 million-asset institution in Lynnwood, Wash., recently received what we believe was the first post-FIRREA approval by the Office of Thrift Supervision of a savings-bank charter conversion.

The conversion was facilitated by the strong capital position of Pioneer and the active cooperation of the state supervisor and his office in reviewing the application.

The supervisor's office and the FDIC conducted a joint examination of Pioneer. Before the regulatory examination, the Pioneer stockholders met and voted to approve the charter conversion.

Other Conversions in Progress

Several other savings associations in the Washington also are in the process of converting to a state savings banks.

Federal law does not prohibit a savings institution from converting to a state-chartered savings bank.

"The savings-bank charter alternative has become popular, in part, because of the thrift law's elimination of the Federal Savings and Loan Insurance Corp.

In fact, a provision in the thrift law specifies that the five-year moratorium on conversions from the SAIF to the Bank Insurance Fund shall not be construed to prohibit a savings association from converting to a bank charter if the resulting bank remains a SAIF member.

FDIC Status Is Same

Upon converting to a state-chartered mutual savings bank, the deposit insurance status of the institution does not change. Thus, the eligible deposits held at the institution continue to be insured under SAIF and the institution must continue to pay assessments to the FDIC for SAIF insurance.

The applicable state regulatory authority and, ordinarily, the FDIC become the primary regulators of the institution, replacing the OTS.

Also, the institution may remain a member of the Federal Home Loan Bank System, assuming continued compliance with the qualified thrift investment requirements.

The staffs of the OTS and the FDIC have acknowledged that such conversions are permissible, with the caveat that policy implications would arise if the converting institution has safety and soundness problems.

OTS Application Required

With respect to the termination of its current charter, an institution must file an application with the OTS. No formal conversion-related application must be filed with the FDIC. State and FDIC examinations of the institution, however, usually are required before the final approval of the conversion.

Ordinarily, the applicable state law requires the adoption of a plan of conversion by a majority of the members of the institution's board of directors and approval of the conversion by a majority of the stockholders or members of the institution.

The advantages in converting to a state savings bank may include the benefits of being regulated and supervised by a regulator in the institution's home state, reduced costs in examination and supervisory fees, and more favorable lending and investment powers.

Charter flips to a state savings bank also do not require an institution to recapture any portion of its bad-debt reserve.

In addition, in situations in which the converting institution is owned by a savings and loan holding company, the conversion process is further simplified because of the ease by which a vote of the stockholders, namely the holding company, may be obtained.

Higher Capital Requirements

One possible disadvantage in converting to a state savings bank is the higher capital requirements imposed by the FDIC. The FDIC presently requires a primary capital ratio of 5.5% and total capital of 6%. These contrast with OTS core and tangible capital requirements of 3% and 1.5% respectively.

The risk-based capital requirements of both the FDIC and the OTS are essentially the same. The FDIC, however, has a two-tiered phase-in of the risk-based capital requirements, unlike the OTS, which has an interim phase-in requirement of 6.4% until Jan. 1, 1991, when the OTS and the FDIC both will enforce the 7.2% requirement.

A Regulatory Test

An additional issue to address in connection with such a charter conversion is whether the FDIC will deem the institution to be a savings bank under the Federal Deposit Insurance Act and thus consider the institution a state nonmember bank, so as to come within the primary regulatory jurisdiction of the FDIC.

"The advantages in converting may include being regulated and supervised in the institution's home state and more favorable lending and investment powers."

The test under the FDI Act in this respect is whether the applicable state law imposes "special requirements on such banks governing the manner of investing their funds and conducting their business."

If the FDIC determines that the institution does not so qualify, then the institution would continue to be deemed a savings association, and thus would continue to be regulated by the OTS.

Indiana recently passed a law permitting the conversion of mutual federal and state savings associations to Indiana mutual savings banks. The law becomes effective July 1, 1990.

Other States Consider Change

Also, New Jersey, Wisconsin, and Illinois, among others, are in the process of considering either savings bank charters or charter conversion provisions.

Charter flips to a state savings bank may not be available or advisable for all savings associations, but those that are eligible for such a conversion should give some thought to the option. □

LETTERS *to the editor*

Rose Wins Jeers, Cheers for Blast At Greenspan Call for More Capital

To the Editor:

I'm surprised that in 1990 a commentary such as Sanford Rose's July 24 article regarding bank capital ["For Shame, Chairman Greenspan!" on page 1] is deemed worthy of printing.

I've been a bank regulator, both state and federal, for 34 years, and I've never seen a bank fail because of too much capital.

I've seen them fail because of inadequate capital, and that's the point: The greater the risk in an institution, the more capital is required.

Time and time again, bankers want to leverage their minimal equity capital to the point that a minor downturn in the economy leaves them with insufficient capital to absorb loan losses.

Safety and Soundness

I also know that when investors and shareholders have sizable investments in a bank they take a special interest in safety and soundness.

Maybe we should go back to requiring shareholders to be subject to a mandatory call for capital contributions in time of need. That way, the taxpayers won't need to have their checkbooks handy.

Thomas K. Desch
Senior Vice President
Federal Reserve Bank
Philadelphia

To the Editor:

As a frequent reader of Sanford Rose's columns in the *American Banker*, I was particularly impressed with the July 24 commentary on Alan Greenspan's proposal for raising bank capital.

As Mr. Rose suggested, its likely effect is to cause bank managements to take yet greater risks in order to achieve the yields necessary to justify and sustain higher capital levels.

This seems to me to be the same mechanism that caused the massive losses in the savings and loan industry – managements, abetted by the easy availability of federally insured funds, seeking higher and higher yields to compensate for mounting losses on earlier risks.

There is, in my view, no way to address this problem within the current system. Your views on Alan Greenspan's approach suggested to me that my own proposal for a privatized deposit insurance system, utilizing the capital of the banking industry, would be of some interest.

Privatization offers a mechanism for introducing the right kind of market discipline into the deposit insurance system and forcing unproductive capital out of the banking industry.

Peter J. Wallison
Gibson Dunn & Crutcher
Washington, D.C.

Editor's Note: Mr. Wallison was White House counsel to President Reagan and chief counsel to the Treasury Department under Donald Regan.

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Established 1836
One State Street Plaza, New York, N.Y. 10004
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Second Class Postage Paid at new York, N.Y., and at additional mailing offices in U.S.A.
(ISSN No. 0002-7561)
Postmaster: Send address changes to American Banker, One State Street Plaza, New York, N.Y. 10004
Subscription Rates: U.S. $635 a year, Canada $815. Canada Airmail and Foreign $1,120. Single copies: $5.75. Special issues: $25 or $55. Back-issue prices based on date of publication.
Telecopier: 212-943-2984

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DEALS

SAS Taps Morgan for Buyout of Lorenzo's Stake in Continental Airlines

By JED HOROWITZ

Morgan Guaranty Trust Co. is advising Scandinavian Airlines System on its buyout of Frank Lorenzo's stake in Continental Airlines Holdings Inc., according to spokesmen for the bank and the buyer.

SAS will invest $50 million, about $27 million of which will go to the controversial Mr. Lorenzo in return for his stepping down as head of the airline.

The SAS mandate, while relatively small, represents something of a coup for the J.P. Morgan & Co. unit in a climate not too conducive to dealmaking.

Role in IBM Transaction

Just last week the bank emerged as an adviser to IBM Corp., which plans to sell most of its low-technology businesses to Clayton & Dubilier for a price believed to exceed $2 billion. Morgan does not have the sole advisory mandate in the IBM transaction, but is expected to be one of three lead banks financing the IBM buyout.

The SAS transaction is not expected to require bank financing, said Charles Dumas, a managing director in the bank's mergers and acquisitions division.

Morgan, which has been working on the airline deal for more than a year, previously advised SAS on its unsuccessful bids for a portion of Aerolineas Argentinas and British Caledonian Airways, Mr. Dumas said.

Lorenzo's Contract a Factor

SAS will buy Jet Capital Corp., a company that holds 2% of Continental Airlines' capital and is 48% owned by Frank Lorenzo. The European airline – which is 50% controlled by the governments of Sweden, Denmark, and Norway – is paying about $20 million for Jet and $20 million to buy out Mr. Lorenzo's five-year contract.

The SAS bid is not expected to require bank financing.

Mr. Lorenzo – whose empire once included Eastern Airlines, now in Chapter 11 bankruptcy proceedings – will receive about $27 million from the transaction, Mr. Dumas said.

SAS also is injecting about $10 million into Continental, a company formerly known as Texas Air Corp. SAS, which already owns 9.9% of Continental, will emerge with 16.8% of stock and 18.4% of voting control if the purchase wins approval from the U.S. Department of Transportation and from Mr. Lorenzo's approximately 90 partners in Jet Capital.

The purchase price of about $15.30 per share is well above the $4.50 at which Continental's common stock was trading before the deal was revealed in Thursday's edition of *The Wall Street Journal*. SAS, a long-term client of Morgan, probably will fund the purchase out of its current treasury, Mr. Dumas said. SAS officials did not return calls for comment. □

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Day of Reckoning Nears for Interest on High-Yield Debt

Continued from *page* 1

creasing through 1995, billions of dollars of these PIKs and zeros have to begin paying interest in cash. In addition, billions of dollars worth of junk bonds carrying resettable coupons will get new rates in 1991 and 1992.

All these factors will significantly increase the cash interest costs of many companies that were taken private or recapitalized in the 1980s. When the interest payments kick in, some companies' coverage ratios will fall to potentially troubling levels that could put them in violation of loan covenants, or worse, bankers and analysts warn.

The silver lining for banks is that many of these securities trade at a discount, and many companies in solid financial shape will be coming to banks for refinancing, since the new-issue market in high-yield bonds is nonexistent.

Opportunities for Borrowers

Any company that can buy its bonds back at a discount increases its equity – while reducing overall indebtedness – by booking the gain on the difference between the retirement price and par, noted Kingman Penniman, senior vice president at McCarthy, Cristanti & Maffei, a junk bond research firm.

Creditworthy companies will likely find banks willing to refinance, given the lenders' need to put funds to work in high-yielding assets, bankers say. RJR Nabisco Inc., for instance, is solving its PIK problem through a combination of financings that include a new $2.25 billion bank loan. And Santa Fe Pacific Corp. is speaking with its banks about a major refinancing.

Bankers, in fact, say they have targeted companies with junk bonds as potential lending opportunities, noting that any debt retired at a discount can greatly improve the credit. Companies that have paid down senior bank debt will have the easiest time arranging new bank loans, lenders said.

"If banks can see that it will enhance the credit, you'll see more of that," Mr. Penniman said.

Lenders Are Receptive

"Some companies are taking constructive steps to make them viable concerns. And banks are saying: 'If a company has a good track record and has made a significant effort to reduce bank debt, it behooves us to lend,' " he added.

"The willingess of banks to refinance is a function of how well a company has done," said Mark Gold, a vice president at Chancellor Senior Secured Management Inc., a mutual fund that invests in bank loans. "If a company has paid off a lot of debt, they might find that banks may be willing to come in and take out the PIKs."

The idea behind noncash high-yield securities seems dubious in retrospect. The deals assumed that operating income would grow, and that asset sales would be successful.

Many deals crafted in the mid to late '80s used zero-coupon bonds or so-called cramdown securities – technically "merger debentures" that were distributed, or "crammed down" the throats of shareholders in lieu of cash for a buyout.

Use of the securities allowed acquirers to raise their bids without arranging more financing, since the bonds deferred cash interest for a number of years by paying in additional securities.

No Longer 'Academic'

But because many acquirers "never expected to be around five years later, it was sort of an academic issue," says a veteran LBO lender. It's no longer academic.

For companies like Viacom Inc. and Owens-Corning Fiberglas Corp. that are in solid financial shape, banks hungry for high-yielding assets are likely to target the outstanding PIKs for refinancing.

While many "trigger" dates don't kick in until next year, bankers and analysts say companies that have access to additional capital are not likely to wait until the bonds begin paying cash.

"They want to deal with it six to nine months before the things kick in," said one banker.

Coping with Event Risk

Santa Fe Pacific, for instance, has PIKs that don't start paying cash until 1992, but is moving now to deal with the "event risk" embedded in its balance sheet.

The Chicago-based company recently announced that it was exchanging $200 million of its $780 million PIK that becomes cash pay in 1992 for cash and common stock, and will call the rest of the tranche in October. The cramdown PIKs were issued as part of a recapitalization two years ago.

Analysts expect the company to arrange a new $400 million bank facility to call the bulk of the outstanding bonds.

Bank Debt Replaces 'Junk'

"Some of the new financing will be a bank facility," confirmed Robert Gehrt, a spokesman for the company. "We're in the process of negotiating that... We've met with them and they know what we're trying to do." The company's agent banks are the banking units of Chase Manhattan Corp., Chemical Banking Corp., J.P. Morgan & Co., and Security Pacific Corp.

"Companies are going to move before it becomes a problem," Mr. Penniman said.

For many companies, though, it will not be quite so easy. On the marginal deals that banks will not refinance, they may nevertheless have senior loans outstanding from the original transaction that could look much worse off with a PIK paying cash.

"For banks, it's a problem for weaker deals," said one lender to leveraged transactions. "There will be some opportunities, but on the whole I think it's a problem."

Timetable for Cash Payments

In 1991, about $1 billion in PIKs and $4.5 billion in zeros start paying cash interest, according to data from Salomon Brothers Inc. In 1992, a bit less than $1 billion in PIKs and around $3.6 billion of zeros become cash pay.

In 1993, the PIK figure jumps to $2.2 billion, while the amount of zeros skyrockets to just over $6 billion. In 1994, $1.485 billion in PIKs become cash pay, while a whopping $7.3 billion in zeros kick in. The figures assume that RJR Nabisco leaves outstanding $330 million of its 17% PIKs due in 2009 and $2.3 billion of its 17% PIKs due in 2007.

For resets, $3.2 billion of public and private junk bonds will be reset next year, $1.72 billion in 1992, then falling to $706 million in '93, according to Salomon Brothers.

Leveraged Roll Call

Leveraged companies with debt that becomes cash pay include: Jack Eckert Corp. – $345 million in zero-coupon bonds, May 1991; Owens Corning Fiberglas – $1 billion in zeros, December 1991; National Gypsum Co. – $847 million in zeros with 15.5% coupon, June 1991; and Viacom – $449 million in PIKs at 15.5% interest, June 1991.

Most of these companies will likely be able to refinance or meet their cash interest obligations, but companies like Southland Corp. – with $402 million in zero-coupon bonds that pay in cash next year – clearly will not.

And the increased risk of a recession stemming from the Middle East crisis could put pressure on cyclical companies, further tipping the marginal deals into potentially distressed situations, bankers warned.

Tarnished in Hindsight

The idea behind noncash high-yield securities seems dubious in retrospect. The deals were structured on the assumptions that operating income would grow, and that asset sales would be successful.

In the case of Interco Inc., which has $213 million in bonds that become cash pay in 1993, neither worked; it's clear that the company and its investment bankers were using a rose-colored calculator.

Banks began to target junk bond buybacks as a potential opportunity after Campeau Corp.'s failure sent the junk bond prices of many leveraged deals plunging. It's an opportunity to lend at leveraged pricing and with fees in the range of 300 to 400 basis points. □

AMERICAN BANKER

VOL. CLV NO. 159 Wednesday, August 15, 1990 155th year

NEWSPAPER 155389000015 2/ 5/07 C11
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Bankers Foresee 3% Capital Rule Stifling Growth

By LINDA CORMAN

WASHINGTON — Federal Reserve Board officials insist most banks have little reason to contest its most recent minimum capital requirement, known as the 3% leverage ratio. But some bankers disagree as controversy lingers over the usefulness of this method of measuring capital.

The standard, adopted Aug. 2 by the Fed – other regulators are soon to follow – requires the strongest banks to hold equity capital equal to at least 3% of assets. Bank health is measured on the regulators' Camel scale, an index based on capital, asset quality, management, earnings, and liquidity.

ANALYSIS: *Follow-up on the news*

Lower-rated banks will have to maintain leverage ratios at least one percentage point higher than 3%. The leverage ratio must be met in tandem with the broader, risk-based capital requirement. At the end of this year, for example, banks must meet both the 7.25% risk-based standard and the 3% capital requirement.

Problem Only in U.S.

Therein lies the rub for U.S. banks. While most major foreign banks must comply with risk-based capital rules, they do not have to worry about the additional requirement that, in effect, limits U.S. banks' ability to leverage their assets.

The 3% capital must consist of Tier 1 capital, defined as common equity and perpetual preferred. State institutions must deduct goodwill.

Much of the debate over the risk-based capital requirements occurred several years ago in anticipation of the international negotiations that culminated in the Basel accords, which made the risk-based requirements an international standard.

The Fed, however, has gone beyond the Basel agreement by adopting the 3% leverage ratio as well, which some domestic bankers say will hinder them in competition with overseas institutions not equally restricted.

Problem for Some Banks

U.S. bankers also argue the 3% leverage ratio prevents a bank with a large portfolio of low-risk assets from taking full advantage of the risk-based capital standards.

Beyond the dispute over the leverage ratio, analysts say banks already are on edge. To meet higher capital minimums,

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INSIDE NEWS

THRIFT CRISIS

COLUMBIA SAVINGS and Loan Assoc. announced that it lost $136.5 million in the second quarter. The loss increased Columbia's capital deficit 63% to $352.1 million, increasing the likelihood that it will be seized by regulators. *Page 2*

THE RESOLUTION Trust Corp. decided to extend to all investors the same quality guarantees on mortgage-related assets that it gives the governmental secondary-market agencies. *Page 2*

TECHNOLOGY

A POWER OUTAGE in New York's financial district continued to disrupt many back-office bank operations on Tuesday, as institutions diverted resources to keep trading and funds-transfer areas working smoothly. *Page 3*

FINANCE

THE SPIKE IN RATES on government securities could hold for a while, and a debate is emerging over whether the rate increase and resulting plunge in prices has further wounded the already limping banking industry. *Page 24*

CITICORP, First Chicago, and Bank of Boston, among others, are expected to look long and hard before agreeing to a plan by Atlanta developer John C. Portman to give his unsecured lenders a security lien. *Page 22*

CONSUMER

THE CIRRUS and Plus networks can proceed with their plans to share automated teller machines without fear of antitrust litigation – at least for now. *Page 8*

INTERNATIONAL

BANK OF MONTREAL caught industry analysts and money market participants off guard when it cut its prime rate to 14.25% from 14.75%. *Page 14*

COMMENT

REGULATORS are in the process of rethinking their position on the treatment of asset sales with recourse, writes Gail Patelunas. *Page 4*

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FDIC Premiums to Skyrocket 63%

Insurer Votes Largest Allowable Increase for 1991

By BILL ATKINSON

WASHINGTON — Moving to replenish the dwindling bank insurance fund, the Federal Deposit Insurance Corp. board voted Tuesday to raise bank premiums next year by a record 63%.

The proposed increase – the maximum allowed in a single year – is to 19.5 cents for every $100 of insured bank deposits in 1991. The 1990 rate is 12 cents per $100.

In a unanimous vote for the 19.5-cent rate, the five-member FDIC board superseded a scheduled 3-cent rise that had been mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The higher rate for next year would become official after a 30-day period for public comment.

7.5 Cents More in 1992?

The FDIC has authority to consider another 7.5-cent rise in the rate to take effect in 1992.

The move came after a month of hints from FDIC Chairman L. William Seidman and other officials that a premium hike beyond the scheduled 3 cents per $100 was in the offing. While the increase will shore up an insurance fund that is at an all-time low relative to the deposits it covers, bankers and industry analysts have noted that higher insurance premiums will mean lower profits.

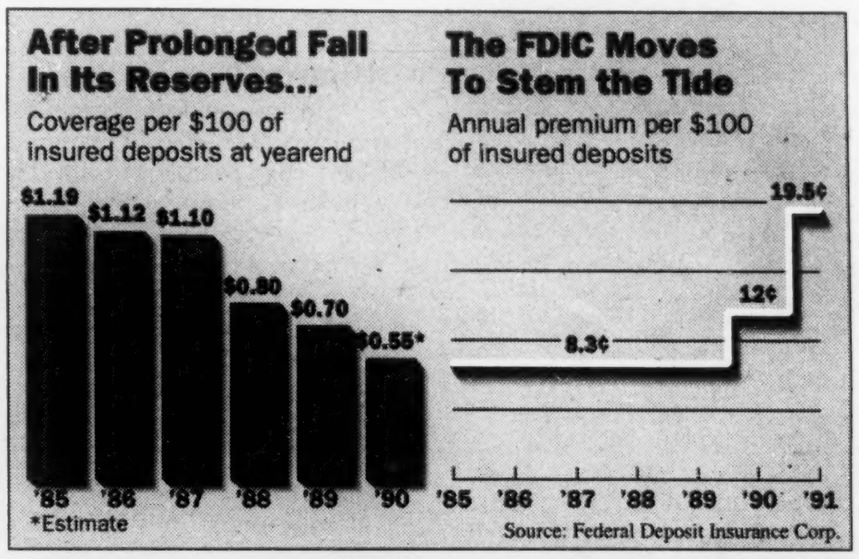
But a study by the FDIC staff concluded that the 7.5-cent assessment increase "would have a minimal impact on current industry capital levels." Commercial banks with deposits backed by the bank insurance fund had $224.7 billion at yearend 1989.

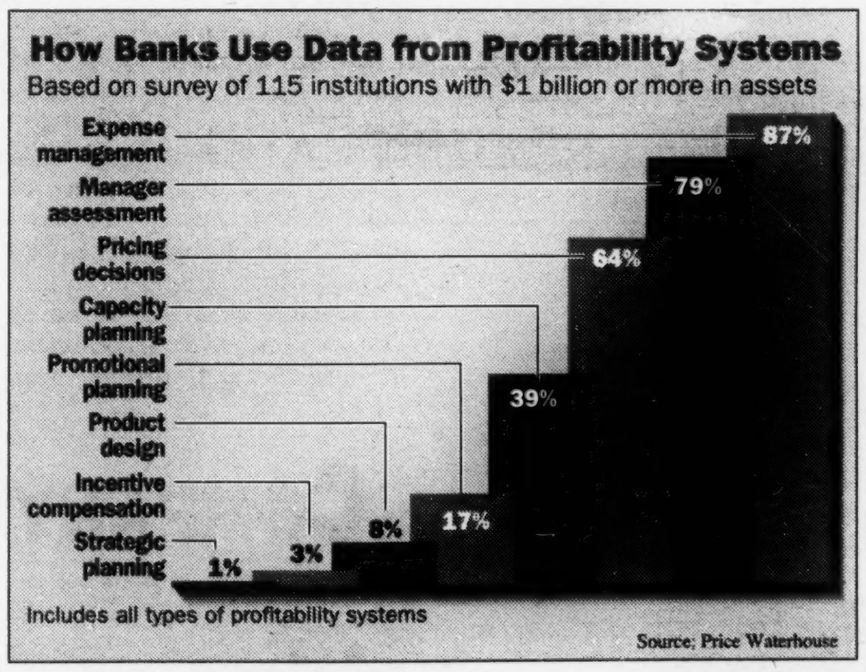
The increase in the premium will affect only commercial banks, which since 1989 will have seen a 135% boost in their premium rates, from 8.3 cents to 19.5 cents. Thrifts backed by the savings association insurance fund, which now pay 20.8 cents per $100, are to pay 23 cents next year.

Impact on Bank Costs

At the 19.5-cent premium level, banks insured by the FDIC's bank fund face a $1.1 billion in-

See **FDIC** *page* **12**





Major Banks Seeking to Calculate Profitability of Products, Clients

By RICHARD LAYNE

In an attempt to bolster stock prices and allocate capital more effectively, major banks are building sophisticated information systems that measure the profitability of individual products, customers, and lines of business.

While many sizable banks can measure profitability company-wide, only a handful have taken the next, crucial step: installing systems that measure the risk-adjusted return on equity for business units. With such systems, banks can manage their enterprises with the same eye to unit costs and dead wood that a manufacturer has.

About six of the nation's 20 largest banks have already developed such systems, including Security Pacific Corp., Bankers Trust New York Corp., First Chicago Corp., and Mellon Bank Corp., according to James M. McCormick, president of the First Manhattan Consulting Group, New York. Another eight or so, including Chase Manhattan Corp., Chemical Banking Corp., and PNC Financial Corp., are in the midst of de-

See **BIG** *page* **10**

Global Data: U.S. Banks In Retreat

By JOHN EVANS

LONDON — Plagued with rising credit problems and worldwide concern about the health of the U.S. banking industry, American banks staged a major retreat from international credit activities in the first quarter, according to the Bank for International Settlements.

U.S. overseas banking assets fell $47 billion, or 8%, to $550.8 billion from the period ended Dec. 31, the Basel-based central banking organization said in a report prepared for release today. Foreign borrowings of U.S. banks declined $36 billion, or 6%, to $611.2 billion.

The BIS said the reduction was the sharpest it every recorded, surpassing a 4% decline of U.S. banking assets overseas and a 3% decline in liabilities in the quarter ended June 30, 1989.

All Areas Involved

The scaling-back of the international activities of American banks was worldwide and involved "all geographical areas and included both interbank and final lending business," the BIS said. The reduction in the first quarter reflected "the grow-

See **U.S. BANKS** *page* **14**

COMMENT / *By Gail Patelunas*

Regulators Examining Risk In Asset Sales with Recourse

Presently, banks and savings associations do not follow the same practices in reporting asset sales with recourse for regulatory reporting nor in calculating capital adequacy. For both banks and savings associations, the divergence between regulatory reporting and capital requirements presently requires capital for recourse contingencies twice for the same institution.

An allowance is established for estimated credit losses at the time of sale, and capital is generally required for the off-balance sheet recourse contingency as if the assets sold were still on the institution's books.

These treatments impact competition, pricing, and efficiencies of the secondary market for mortgages.

This article will look at how recourse is treated by banks and savings associations for regulatory reporting and capital adequacy purposes and some of the issues presented by these treatments.

Positions Under Review

The regulators are in the process of rethinking their position on the treatment of asset sales with recourse, given the convergence of savings association regulations with those for banks and the Financial Institutions Reform, Recovery, and Enforcement Act mandate for the federal thrift and banking agencies to establish uniform regulatory accounting standards.

The Federal Financial Institutions Examination Council recently issued a request for public comment on recourse arrangements. The paper addresses a wide range of recourse arrangements, regulatory reporting requirements and the capital ramifications. Issues covered include:

- When is a sale with recourse a sale?
- When is it a financing?
- How does recourse affect the amount of capital required to support the activity?
- Should regulatory reporting differ from generally accepted accounting principles in this area?

Comments received in response to this request will ultimately affect the way in which asset sales are reported for regulatory purposes and the amount of capital required for the recourse contingency.

Risks Taken in Early 1980s

Prior to the adoption of risk-based capital guidelines, capital requirements for banks were only levied against balance sheet assets. Formalization of bank capital guidelines in the early 1980s encouraged management to take risks off the balance sheet, thus spawning new products and variations of securitization and asset sales with recourse.

This article addresses recourse as a credit enhancement only. Many other forms of recourse exist to protect the investor from such things as interest rate risk and risks stemming from natural disaster.

Heretofore, savings associations' capital requirements were based on liabilities and other risk factors, rather than on assets and the attendant credit risks. Savings associations took advantage of securitization to restructure their balance sheets and stabilize and grow earnings through risk-controlled arbitrage.

Mortage-Backed Securities

The securitization market has grown substantially in the past decade providing a liquid secondary market for mortgages on one- to four-family homes. The volume of mortgage-backed securities has grown from $373 billion at year-end 1985 to $859 billion by the third quarter of 1989, or more than 238%, compounded annually.

Regulators have recognized risks presented by the growing volume of recourse assumed during the securitization process and have taken steps to measure it and require capital for the credit risk it presents. In this effort, bank call reports have been modified by adding supporting schedules to capture information regarding the amount of loans sold each quarter and the amount of recourse retained by the selling institutions.

In all but limited situations, banks do not follow generally accepted accounting principles in reporting asset sales with recourse for regulatory reporting, nor in calculating capital requirements. Under generally accepted accounting principles, assets sold with recourse can be removed from the balance sheet provided certain requirements are met.

"Regulators have recognized risks presented by the growing volume of recourse assumed during the securitization process and have taken steps."

However, under regulatory reporting for banks, if a sale results in the retention of recourse, the transaction is treated as a financing for regulatory reporting; the asset is not removed from the balance sheet. The Call Report instructions specifically state that this treatment is "for purposes of . . . determination of capital adequacy."

Secondary Mortgage Markets

One major exception to this rule exists for the sale or swapping of mortgages to one of the federal or federally-sponsored agencies. In such instances, the reporting bank may account for the transaction as a sale for regulatory reporting purposes, thereby removing the mortgages from the balance sheet even if risk is retained. (Where no risk is retained, securitized mortgages can reduce the amount of capital required under the risk-based guidelines from 50 to 20%, or even to zero, based on the weight assigned to the security.)

During the development of the secondary mortgage markets, banks soon found that the best prices could be obtained if recourse was retained for 100% of the mortgages, since the securitized assets were still treated as a sale for regulatory reporting purposes.

Privately issued mortgage-backed transactions also may be accounted for as a sale for regulatory reporting, depending on the structure and amount of risk retained. If the selling bank retains recourse representing less than a "significant risk of loss," the transaction is reported as a sale for regulatory reporting purposes, and the mortgages are removed from the balance sheet.

A "significant risk of loss" exists when the maximum contractual recourse exposure retained by a bank exceeds its estimated probable loss. Many private deals do not meet the test for treatment as a sale because the recourse retained is several times the amount of the expected losses.

Capital Requirements for Loans

For regulatory capital requirements, removing assets from the balance sheet reduces capital requirements for the leverage ratio which is calculated using balance sheet assets. However, recourse retained on mortgages sold requires the selling bank to hold capital for the entire amount of loans sold under the risk-based capital ratio as if the loans were still on the books.

If the security is held by the securitizing bank, it is not required to be capitalized in addition to the underlying mortgages. However, if the security is subsequently sold, capital is required to be maintained by both the depository institution that securitized the loans with recourse, and the depository institution purchasing the security. This is referred to as "double counting," that is, the original mortgages now require capital twice within the banking system, by the holder of recourse and by the purchaser of the security.

In addition, the diverging treatment of recourse under generally accepted accounting principles and for capital adequacy purposes is the equivalent of requiring capital twice for the same bank. A number of large players in the residential mortgage market are publicly reporting banking organizations using generally accepted accounting principles.

Under GAAP, a bank's obligation under the recourse arrangement is estimated and a allowance is established for this contingency at the time of the sale. However, this allowance for loss no longer counts as capital under the new risk-based capital calculations.

Under the capital requirements, capital is required to be held for recourse on the securitized assets. Therefore, under GAAP, a charge to income is taken to establish an allowance for the recourse contingency, but capital is still required to be maintained.

Savings Associations

Savings associations are required to follow generally accepted accounting principles in regulatory reporting for asset sales with recourse. Like banks, assets sold with recourse can be removed from the balance sheet, thereby reducing capital for the leverage requirement. And, like banks, savings associations must hold capital for recourse provisions under the risk-based capital framework.

However, the capital requirement for savings associations is slightly different from that for banks. The leverage requirement is somewhat easier for savings associations to meet, given their ability to report sales with recourse in accordance with GAAP, regardless of whether they are to agencies or without a significant risk of loss.

Banks are only accorded this exception in limited instances. Savings associations are required to maintain risk-based

See **COMMENT** *page* **6**

Ms. Patelunas is a senior manager with KPMG Peat Marwick in Washington, working in its financial institutions advisory service.

LETTERS *to the editor*

Chemical Chief: Shake-Up Gives More Responsibilities to Hartigan

To the Editor:

Chemical Banking Corp. would like to lodge a strong protest over a reference to one of our senior executives, Maurice H. Hartigan II, in an article on Aug. 9 ("Younger Executives Gain in a Shake-Up at Chemical," page 1).

The article said that Mr. Hartigan became an "apparent also-ran" under a realignment of Chemical's top management and implied that his duties were changed because Chemical's real estate lending is "troubled." Both contentions are incorrect.

Under Mr. Hartigan's leadership, Chemical reduced its real estate lending by 22% since 1988. Mr. Hartigan also shifted Chemical's focus away from construction lending, which is now the most troubled part of the market, toward lower-risk types of lending and advisory activities. Recent developments in the real estate market clearly prove that his conservative strategy was correct.

Rather than becoming an "also-ran" under the new structure, Mr. Hartigan has assumed much broader responsibilities as the No. 2 executive in charge of Chemical's New York region, including our consumer, middle market, and private banking businesses, as well as real estate.

Walter V. Shipley
Chairman
Chemical Banking Corp.
New York

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Second Class Postage Paid at new York, N.Y., and at additional mailing offices in U.S.A.
(ISSN No. 0002-7561)
Postmaster: Send address changes to American Banker, One State Street Plaza, New York, N.Y. 10004
Subscription Rates: U.S. $635 a year, Canada $815. Canada Airmail and Foreign $1,120. Single copies: $5.75. Special issues: $25 or $55. Back-issue prices based on date of publication.
Telecopier: 212-943-2984

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Big Banks Seek Deeper Data on Profitability to Aid Stock

Continued from *page* **1**

veloping them, he said.

The growing importance of these systems has not gone unnoticed on Wall Street. Analysts say that banks lacking these systems are more likely to stay in losing businesses and fail to back potential winners.

These profitability systems, which cost millions of dollars to design and install and can require a bank to solve some knotty accounting problems on allocating equity, are the managerial tools of choice for a new breed of executive.

An Eye on Risk and Reward

Observers call this group "systematic managers," for their focus on managing businesses based on apples-to-apples comparisons of such performance criteria as risk-adjusted return on equity for business lines.

Members of this new class say they can strengthen their companies' return on equity by as much as two percentage points. The average return on equity for all banks last year was 7.79%, while in 1988 it was 12.79%. Return on equity, or ROE, is a significant determinant of stock value.

The need for profitability systems is spurred by the growing complexity of the banking business. A bank operating 100 lines of business in several states must be able to optimally price products and decide on a quantitative basis, primarily ROE, which business to exit or build up.

"Banks that have this capability have a leg up on understanding their resources," said Arthur P. Soter, a banking analyst with Morgan Stanley & Co.

"That doesn't guarantee success, but it increases the likelihood that they are putting their money to work in the better opportunities."

Mr. Soter said the use of a profitability-measurement systems was a key factor in the recent turnaround of Detroit-based Comerica Inc.

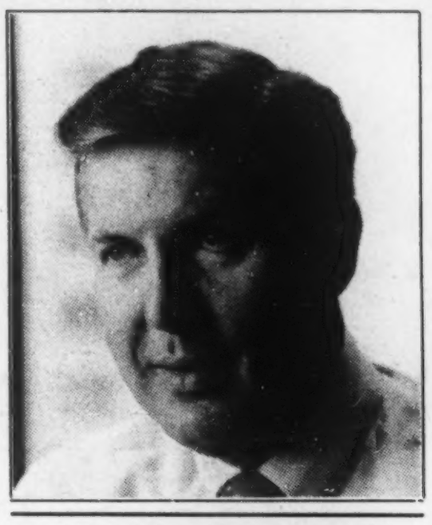
"Not having such a system hurts banks," said Diogo B. Teixeira, a banking technology specialist with McKinsey & Co. If "you don't know your product profitability, it's hard to make the right decision on how to price a product or whether to drop out of a business."

Setting the Standards

At a meeting last month in San Diego, Security Pacific's top 85 managers sat on the edges of their seats while executives announced which of the bank's 49 major businesses reached the goal of a 20% ROE. Fourteen businesses did not. The result: Security Pacific plans to announce the sale of some units and will restructure others.

For Security Pacific, the focus on ROE, derived via the profitability system, is new. "We've never been able to monitor these businesses as well before – you had some gut feelings, but you couldn't prove them," said John Singleton, the new chief operating officer at Security Pacific.

"In manufacturing, you live and die by unit costs and product costs," said Mr. Singleton. "Banking never had to do this."



"You had some gut feelings, but you couldn't prove them."

John Singleton
Security Pacific Corp.

A Heavyweight Group

Mr. Singleton is one of the new systematic managers, a group that includes Edward Miller, vice chairman of Manufacturers Hanover Trust Co., New York; Terrence A. Larsen, chairman of CoreStates Financial Corp., Philadelphia; and Anthony P. Terracciano, who used such a system at Mellon before taking the top job at First Fidelity Bancorp, Newark, N.J.

Executives at Security Pacific believe the the system can increase ROE by 1.5 to 2 points. "If you are going to be a powerhouse acquirer, you have to drive your stock price up," said Mr. Singleton.

Security Pacific is not alone. At CoreStates, which finished its profitability system last year, hundreds of financial analysts, wholesale bankers, and even the chairman, Terry Larsen, check the system regularly, monitoring the performance of customers, business units, and products, according to Robert N. Gilmore, executive vice president.

Other banks must follow the example of these pioneers, according to observers.

"How can you manage without knowing how profitable your businesses are?" asks Mr. McCormick of First Manhattan Consulting .

Mr. McCormick said the first profitability system was installed in 1983, although he declined to name the bank.

Mr. McCormick said that in a sizable bank holding company with some 100 businesses, a third have a high ROE; a third have an ROE from 10% to 20%; and a third have an ROE of less than 10%.

"Once you know the ROE for lines of business, you behave fundamentally different – you know whether to fix, restructure, or wind down," he said. "That's the world that allows for the systematic management for shareholder value."

While few banks have systems that measure return on equity, most can measure profitability to some degree.

In a 1989 survey by the accounting company Price Waterhouse & Co. of 115 of the 250 biggest bank holding companies, all but a few said they had at least some ability to measure the organizational unit profitability, whether through return on assets, net income, or performance to budget. The study said product and customer profitability systems were far less common.

The Price Waterhouse study did find that two out of every three bank holding companies with more than $1 billion in assets said they planned to install or enhance their profitability system within two years.

Accounting Needs Work

Building profitability systems is an enormous undertaking. First, the bank must hammer out the accounting practices: how to allocate equity, funds transfer pricing, and goodwill, to name just a few.

Then it must overcome the technological hurdles. A profitability system sits on top of a bank's transaction processing systems. It must snatch up-to-the-minute information from scores of systems to create individual balance sheets and income statements on balances.

Then the data gleaned from the bank's operations must be stored in such a way that managers can easily retrieve it.

Mr. Soter and others point to the unique problems of banks as compared with other industries that has slowed this progress: a lack of separation between lines of business, issues in transfer pricing, the allocation of capital.

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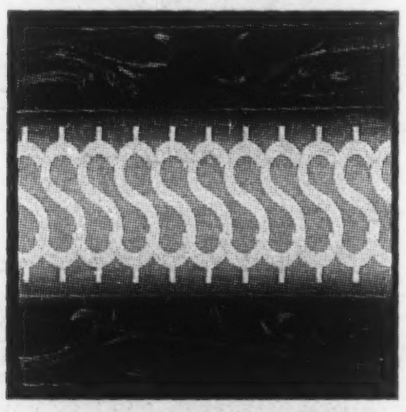

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ISSUES
Machine Dialing Speeds Collections

By KAREN GULLO

NEW YORK — Using technology that automates telephone dialing, banks have discovered that they can greatly speed collection operations, reduce labor costs, and increase their telemarketers' productivity.

Banks began installing automatic or "predictive" dialing systems in the mid-1980s to make collections and telemarketing operations more efficient. Such systems can be programmed to dial several hundred phone numbers an hour and route calls and customer information to operators.

In Massachusetts and a few other states, any company using an autodialing system for telemarketing must buy lists from the phone company of consumers who do not want to receive the calls. So far, banks that use such systems for collections are not covered by such legislation.

200 Bank Installations

Davox Corp., a Billerica, Mass.-based major provider of such systems, said it has installed autodialing systems at about 200 U.S. banks. Citicorp is one of its largest customers, with systems for its nationwide Visa and MasterCard account collection network. Last spring, the banking company ordered $1.4 million worth of Davox products for its regional collection center in Erlanger, Ky.

A typical system uses personal and mainframe computers with a dialing device. The mainframe sorts delinquent files with customers' names, addresses, and phone numbers and sends them to the PC.

Contacting More People

The PC is programmed with calling criteria that sort the accounts by area code and delinquency period. The information is passed to the autodialer, which begins dialing numbers in rapid succession and passing answered calls to operators.

"The system allows us to talk to more people," said William H. Haddock, collection manager in the credit card group at Star Banc Corp., Cincinnati.

His company installed its first Davox system in the loan collection department two years ago. With 5,000 delinquent accounts to contact each day, collections moved slowly; operators contacted two to five customers an hour. The automatic dialing system picked up the pace to 20 to 35 calls an hour. □

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